



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Release Number: **201123042**

Release Date: 6/10/2011

Date: March 15, 2011

Uniform Issue List Numbers:

512.04-00

1221.00-00

1222.01-00

1234A.00-00

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

University =

State =

Trust =

Dear

This is in response to your letter dated December 10, 2009, in which you request rulings regarding the application of the unrelated business income tax provisions of Part III, Subchapter F, Chapter 1, and the capital gains provisions of Subchapter P, Chapter 1 of the Internal Revenue Code (the "Code") to the transaction described below.

Facts

The University is a legal entity formed pursuant to the State constitution and incorporated under State law for the purposes of teaching, research, and public service. In furtherance of those purposes, the University provides educational instruction to students at campuses throughout the State. The University is exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3).

The University manages gift assets held as endowment in its general endowment pool (the "Pool"). The Pool is invested in a highly diversified portfolio of U.S. and foreign stocks, bonds, and other investments. Each year, a portion of each endowment fund invested in the Pool is severed from the Pool and distributed to University campuses and programs to be spent for the purposes set forth by the donors.

The University uses a unit concept with respect to the various endowments that are invested in the Pool. Each endowment is assigned a certain number of Pool Units. The value of a Pool Unit is set monthly, and is based on the value of the underlying Pool investments. Pool Units

may be redeemed for value. Each endowment is entitled to an annual distribution in an amount equal to the spending policy rate per Pool Unit times the number of Pool Units it holds (a "Spending Policy Distribution"). The spending policy rate, determined from time to time by the University, is a percentage of the market value of the investments in the Pool, calculated on a sixty-month rolling average.

The University is the trustee of a number of charitable remainder trusts including the Trust. The Trust is a charitable remainder unitrust within the meaning of section 664(d)(2) of the Code. The sole charitable remainder beneficiary of the Trust is the University.

To date, the Trust's assets have been invested primarily in income and index funds. The investment return experienced by the Pool has outperformed the return experienced by the Trust since its creation. To achieve greater economies of scale in the management of the Trust, a potentially higher investment return for the Trust, and increased diversification of the Trust's investments, the University would like the Trust to participate in the return that the Pool experiences. To that end, the University proposes to enter into a contract with itself, acting in its capacity as trustee of the Trust (the "Contract"), under which the University will issue, and the University, as trustee, will purchase, Pool Units. The value of a Pool Unit would be based on the value of all underlying investment assets held in the Pool, and would have the same value as the "units" that the University uses for internal accounting purposes. Each investment by the Trust in Pool Units will be transacted at the appropriate unit value. The Trust will receive a Spending Policy Distribution, based on the number of Pool Units owned, to the same extent and at the same spending policy rate as any of the various endowments of the University with funds held in the Pool, except that Spending Policy Distributions with respect to Pool Units held by the Trust will be made to the Trust quarterly. The Trust will treat Spending Policy Distributions as ordinary income, regardless of the character of the underlying income of the Pool, whether capital gain, ordinary income, or return of capital.

The University, acting as trustee, may elect to have all or part of a Spending Policy Distribution reinvested in Pool Units at the then-current valuation. In addition, on a quarterly basis, the University may purchase additional Pool Units on the Trust's behalf, or may have part or all of the Pool Units owned by the Trust redeemed for cash, in either case at the then-current value of Pool Units.

The University receives reimbursement for all of its costs with respect to the Pool, and also retains investment managers who receive compensation (including incentive compensation) through charges against the Pool. These charges are thereby borne by all University funds and by any trusts holding Pool Units. The Pool also bears such costs as brokerage expenses.

The University will not charge the Trust a fee for management of the Trust or in connection with the investment by the Trust in Pool Units. The University will not manage funds for any third parties other than entities related to the University. If the Pool's earnings exceed the amount calculated according to the annual spending policy rate declared by the University, any return exceeding the spending policy amounts will increase the principal of the Pool, thus increasing the value of each Pool Unit. The University will not reserve or segregate any part of the Pool's earnings from inclusion in the value of the Pool Units held by the Trust.

The Contract will provide that an investment in Pool Units gives the Trust neither an ownership interest in the underlying assets of the Pool nor any rights with respect to any other trust that invests in Pool Units. Moreover, the Trust will have no right to veto or opt out of any of the Pool's underlying investments, and no power or right to control, direct, supervise, recommend, or review the University's business activities, operations, or decisions with respect to the Pool, except the right to review its individual Spending Policy Distribution computations. The Contract will also provide that, with respect to the issuance and holding of Pool Units, the University is neither a partner nor an agent of the Trust (other than in its capacity as trustee), and the Trust will never be liable for any cost, expense, or payment incurred or due by the University, for which the University is liable, relating to the Pool or the underlying investment assets. The University represents that it will pay any unrelated business income tax generated by any of the investment assets in the Pool, with no deduction taken against unrelated business taxable income for any payments made to the Trust.

Rulings Requested

You have requested the following rulings—

1. The issuance of Pool Units by the University to the Trust, the making or receipt of payments with respect to the Pool Units, or the holding or redemption of the Pool Units will not generate unrelated business taxable income to the University or to the Trust.
2. Pool Units held by the Trust will be treated as capital assets for purposes of section 1221 of the Code, and section 1234A will apply to treat gain or loss from the cancellation, lapse, expiration, or other termination of a Pool Unit as gain or loss from the sale of a capital asset.
3. The redemption of Pool Units by the Trust will generate short-term or long-term capital gain or loss to the Trust, depending on the holding period of the Pool Unit as set forth in section 1222 of the Code.

ISSUE 1

Whether the issuance of Pool Units by the University to the Trust, the making or receipt of Spending Policy Distributions with respect to the Pool Units, and the holding or redemption of Pool Units will generate unrelated business taxable income (within the meaning of section 512(a)(1) of the Code) to the University or to the Trust.

Law

Section 511 of the Code imposes a tax for each taxable year on the unrelated business taxable income of every organization which is exempt from taxation by reason of section 501(a), as well as any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof.

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as the gross income derived from any unrelated trade or business regularly carried on, less the allowable deductions that are directly connected with the carrying on of the trade or business,

computed with the modifications set forth in section 512(b).

Section 512(b)(1) of the Code excludes from “unrelated business taxable income” all dividends, interest, payments with respect to securities loans, amounts received or accrued as consideration for entering into agreements to make loans, and annuities, and all deductions directly connected with such income.

Section 1.512(b)-1(a)(1) of the income tax regulations (the “regulations”) provides that dividends, interest, payments with respect to securities loans, annuities, income from notional principal contracts, other substantially similar income from ordinary and routine investments, and all deductions directly connected with any of the foregoing items of income shall be excluded in computing unrelated business taxable income.

Section 513(a) of the Code defines the term “unrelated trade or business” as any trade or business the conduct of which is not substantially related (aside from the need of an organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3)).

Section 513(c) of the Code provides that the term “trade or business” includes any activity which is carried on for the production of income from the sale of goods or the performance of services.

Section 1.513-1(b) of the regulations states that Congress’s primary objective in adopting the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. On the other hand, where an activity does not possess the characteristics of a trade or business within the meaning of section 162, the unrelated business income tax does not apply since the organization is not in competition with taxable organizations. Accordingly, for purposes of section 513, the term “trade or business” has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Section 1.513-1(d)(1) of the regulations provides that gross income derives from “unrelated trade or business” if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted.

Section 1.513-1(d)(2) of the regulations provides that trade or business is related to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income), and it is “substantially related,” for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the

accomplishment of those purposes. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

Section 664(c)(2) of the Code imposes an excise tax on the unrelated business taxable income (as defined in section 512) for a taxable year of a charitable remainder annuity trust or charitable remainder unitrust (determined as if part III of subchapter F applied to such trust) in the amount of the unrelated business taxable income.

Rev. Rul. 69-528, 1969-2 C.B. 127, concerns an organization that was formed to provide investment services on a fee basis exclusively to organizations exempt under section 501(c)(3) of the Code. It receives funds from the participating exempt organizations, invests in common stocks, reinvests income and realized appreciation, and, upon request, liquidates a participant's interest and distributes the proceeds to the participant. The ruling states that providing investment services on a regular basis for a fee is a trade or business ordinarily carried on for profit. If the services were regularly provided by one tax-exempt organization for other tax-exempt organizations, such activity would constitute unrelated trade or business. Consequently, the organization described in the ruling is not exempt under section 501(c)(3).

Analysis

(a) As to the University

Under the reasoning of Rev. Rul. 69-528, an organization that otherwise qualifies for recognition of exemption under section 501(c)(3) of the Code and provides investment services on a regular basis for a fee to other exempt or nonexempt organizations would be engaged in an unrelated trade or business within the meaning of section 513(a). Such activity would constitute a "trade or business" under section 513(c) of the Code and section 1.513-1(b) of the regulations, and the conduct of such trade or business would not be substantially related (within the meaning of section 1.513-1(d) of the regulations) to the exercise or performance of any purpose or function described in section 501(c)(3). Thus, if the University charged a fee for investment management services provided to organizations unrelated to it, or generated income from the management of the funds invested by such organizations, such activities could result in unrelated business taxable income within the meaning of section 512(a)(1). Here, however, the University is not charging the Trust a fee for its services and not otherwise receiving income from the services it provides to the Trust. Thus, under these circumstances, the University will not receive unrelated business taxable income within the meaning of section 512(a)(1).

The fact that the University will engage in the investment activity for the benefit of individuals who are co-beneficiaries of the Trust at the same time that it engages in investment activity for its own benefit as the remainder beneficiary limits the scope of the service provided to "others" and distinguishes it from a commercial venture.

(b) As to the Trust

The investment of the Trust's assets in Pool Units would be an investment activity, and the receipt of Spending Policy Distributions with respect to those Units would be income from ordinary and routine investments of the type that is excludible from unrelated business taxable income by reason of section 512(b)(1) of the Code and section 1.512(b)-1(a)(1) of the regulations. Thus, neither the Spending Policy Distributions nor the holding or redemption of the Pool Units themselves would result in the receipt of unrelated business taxable income (within the meaning of section 512(a)(1) of the Code) by the Trust on which the Trust would owe an excise tax under section 664(c)(2). For although some of the Pool's other investments might generate unrelated business taxable income, no portion of such income would be attributed or assigned to the Trust merely because its assets are invested in Pool Units.

The holding of Pool Units does not give the Trust beneficial ownership in the Pool. Rather, a Pool Unit represents a mere contractual right to receive Spending Policy Distributions as determined by the University. Furthermore, the commingling of the Trust's assets with other property in the Pool for investment purposes cannot be characterized as a partnership for federal income tax purposes. The University and the Trust do not hold themselves out as partners, and show no intention to join together in the present conduct of an enterprise. On the contrary, the Contract will specifically state that the University is not a partner or an agent of the Trust with respect to the issuance and holding of Pool Units. Furthermore, the proposed arrangement between the University and the Trust has none of the characteristics that are commonly associated with a partnership. The commingling of the Trust's assets with other assets in the Pool does not give the Trust a capital interest in the Pool or any other ownership interest or rights in the other assets in the Pool. An investment in Pool Units does not give the Trust any power or right to control, direct, supervise, recommend, or review the University's business activities, operations, or decisions with respect to the Pool, nor does it give the Trust a right to veto or opt out of any underlying investment in the Pool. Likewise, an investment in Pool Units does not give the Trust a proprietor's interest in the profits and losses of the Pool, but only a right to Spending Policy Distributions. Since the relationship between the University and the Trust is not in the nature of a partnership or agency, the Spending Policy Distributions reflect ordinary income and do not take on the character of the income of the underlying assets. The University would pay any tax owed on the unrelated business taxable income earned by the Pool, with no deduction taken against unrelated business taxable income for any payments made to the Trust.

ISSUES 2 AND 3

2) Whether Pool Units will be treated as capital assets for purposes of Section 1221 of the Code, and whether section 1234A will apply to treat gain or loss from the cancellation, lapse, expiration, or other termination of a Pool Unit as a gain or loss from the sale of a capital asset.

3) Whether the redemption of Pool Units will generate short-term or long-term capital gain or loss to the Trust, depending on the holding period of the Pool Unit, as set forth in section 1222 of the Code.

Law

Section 1222 of the Code provides that capital gain or loss is generated upon the sale or exchange of a capital asset.

Section 1234A of the Code provides that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer shall be treated as gain or loss of a capital asset.

Section 1221 of the Code defines the term “capital asset” as property held by the taxpayer, regardless of whether it is connected with the taxpayer’s trade or business, unless the property meets one of eight listed exceptions: (1) inventory; (2) property of a character which is subject to the allowance for depreciation provided in section 167, or real property used in a trade or business; (3) certain intangible property; (4) accounts receivable acquired in the ordinary course of a trade or business; (5) certain publications of the United States government; (6) certain commodities financial derivatives; (7) certain hedging transactions; and (8) supplies of a type regularly consumed by the taxpayer in the ordinary course of a trade or business. None of these listed exceptions applies to a Pool Unit.

But although section 1221 appears to give broad meaning to the term “capital asset,” the Supreme Court has said that “not everything which can be called property in the ordinary sense and which is outside the statutory exclusions [of section 1221] qualifies as a capital asset.” Rather, “the term ‘capital asset’ is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations involving the realization of appreciation in value accrued over a substantial period of time....” Comm’r v. Gillette Motor Transp., Inc., 364 U.S. 130, 134 (1960) (citing Burnet v. Harmel, 287 U.S. 103, 106 (1932)). Accordingly, the Court has held that certain interests that concededly are “property” in the ordinary sense are not capital assets. For instance, capital gain treatment has been denied for transactions involving payments in return for interests carved out of, or related to, an interest retained by the taxpayer. See, e.g., Comm’r v. P.G. Lake, Inc., 356 U.S. 260 (1958) (denying capital gain treatment on the disposition of certain mineral payments carved out of established oil and gas interests); Hort v. Comm’r, 313 U.S. 28 (1941) (denying capital gain treatment on the disposition of a term of years carved out from a fee simple).

The Supreme Court has also denied capital gain treatment for transactions on the grounds that the payments at issue were a substitute for ordinary income. In Hort, for example, a tenant cancelled its lease in the taxpayer’s building, and paid the taxpayer a cancellation fee. The Court held that the cancellation fee was ordinary income because the cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises. Hort, 313 U.S. at 32. The Court reinforced this “substitute-for-ordinary-income” doctrine in P.G. Lake, stating that “the lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income.” P.G. Lake, 356 U.S. at 265.

Consistent with the substitute-for-ordinary-income doctrine, courts have denied capital gain treatment for transactions involving interests related to compensation for past or future personal

services. See, e.g., Freese v. United States, 455 F.2d 1146 (10th Cir. 1972) (lump sum representing unpaid commissions due under an employment contract); Elliott v. United States, 431 F.2d 1149 (10th Cir. 1970) (lump sum paid for the surrender of right to future sales commissions); Holt v. Comm'r, 303 F.2d 687 (9th Cir. 1962) (payment for interest in films to be produced by taxpayer). Similarly, courts have denied capital gain treatment for interests relating to income already earned or about to be earned. See, e.g., United States v. Midland-Ross Corp., 381 U.S. 54 (1965) (earned original issue discount); Lattera v. Comm'r, 437 F.3d 399 (3d Cir. 2006) (lump sum payment for annual installments of lottery prize); Rhodes' Estate v. Comm'r, 131 F.2d 50 (6th Cir. 1942) (right to dividend that was already declared).

On the other hand, “simply because the property transferred will produce ordinary income, and such income is a major factor in determining the value of the property, does not necessarily mean that the amount received for the property is essentially a lump-sum substitute for ordinary income.” Guggenheim v. Comm'r, 46 T.C. 559, 569 (1966). In Guggenheim, the court focused on whether the taxpayer transferred substantial investment risks in the sale of undivided interests in a stallion. The court noted that if the value of the stallion subsequently increased, the taxpayer would not share in that increase with regard to the interests transferred. Instead, the new owners would receive all the benefits of an increase in the value of the stallion and all the burdens of a decrease in value. Therefore, the court found that the taxpayer had transferred substantial investment risks and was entitled to capital gain treatment on the sale of the interests.

In United States v. Dresser Indus., Inc., 324 F.2d 56 (5th Cir. 1963), the court distinguished between proceeds from the present sale of the future right to earn income, which is capital gain, and the present sale of the future right to earned income, which is ordinary income. The court found that the sale of an income-producing asset was not merely the sale of the right to income already earned, because the taxpayer had an asset that would produce income in the future. Noting that “there is, in law and fact, a vast difference between the present sale of the future right to earn income and the present sale of the future right to earned income,” the court held that the taxpayer’s sale of the asset generated capital gain. Id. at 59.

Similarly, in Comm'r v. Ferrer, 304 F.2d 125 (2d Cir. 1962), the court held that the taxpayer’s surrender of the lease of a play constituted the sale or exchange of a capital asset, despite the fact that receipts from the play would have been ordinary income. Id. at 132. In rejecting the government’s argument against capital gain treatment, the court noted that there was no equivalence between amounts paid for the surrender of the lease and the income that would have been realized by its retention. Id. at 133.

Analysis

The bundle of contract rights represented by a Pool Unit is property, and may be treated as a capital asset for purposes of section 1221 of the Code. The most important characteristic of the Pool Unit is that significant investment risks are associated with, and included in, each Unit. With respect to each Pool Unit, there is an opportunity for appreciation as well as a risk of loss. Each Unit represents a substantial investment by the Trust, and each Unit has an ascertainable basis. The value of each Unit is directly tied to the Pool’s investment performance; poor performance will result in a decrease in the value of each Unit, while performance above the

spending policy rate set by the University will increase the value of each Unit. The opportunity for appreciation, risk of loss, and basis in each Unit are characteristics of other contract rights that are treated as capital assets, for example, financial derivatives, notional principal contracts, mutual fund shares, and corporate stock. Furthermore, the benefits and burdens associated with each Unit are similar to those associated with the property judged to be capital assets in Guggenheim, Dresser, and Ferrer.

In addition, although the Trust will receive ordinary income in the form of the quarterly Spending Policy Distributions that are based on the number of Pool Units owned by the Trust, consideration received upon a redemption of a Pool Unit is not a substitute for what would otherwise be received as an ordinary income payout, whether due and payable or about to be due and payable to the Trust under the terms of the Contract. Rather, the amount paid for a Pool Unit upon a redemption is equal to the value of the Unit on the date of redemption. Unit value on any given date is equal to overall asset value of the Pool divided by the number of Units outstanding. In addition, a Pool Unit is not an interest related to compensation for past or future personal services. Instead, the Unit is an asset that will produce income in the future.

Finally, a Pool Unit does not represent a carve-out of a larger estate retained by the Trust. The appreciation of each Unit is attributable to overall Pool property appreciation, much of which, in turn, is attributable to increases in the value of capital assets in the Pool. The Contract specifically provides that the Trust has no ownership interest or rights to the Pool.

Thus, we conclude that a Pool Unit is a capital asset for purposes of section 1221 of the Code. Furthermore, section 1234A will apply to treat gain or loss from the cancellation, lapse, expiration, or other termination of a Pool Unit as gain or loss from the sale of a capital asset. Consequently, in general, the redemption of a Pool Unit will generate short-term or long-term capital gain or loss to the Trust, depending on the holding period of the Unit.

Conclusion

Accordingly, based on the information submitted in your ruling request, we rule as follows:

1. The issuance of Pool Units by the University to the Trust, the making or receipt of Spending Policy Distributions with respect to Pool Units, and the holding or redemption of Pool Units will not generate unrelated business taxable income (within the meaning of section 512(a)(1) of the Code) to the University or the Trust.
2. A Pool Unit will be treated as a capital asset for purposes of section 1221 of the Code, and section 1234A will apply to treat gain or loss from the cancellation, lapse, expiration, or other termination of a Pool Unit as gain or loss from the sale of a capital asset.
3. The redemption of a Pool Unit will generate short-term or long-term capital gain or loss to the Trust as set forth in section 1222 of the Code, depending on the holding period of the Pool Unit.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed

deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Theodore R. Lieber
Manager, Exempt Organizations
Technical Group 3

Enclosure
Notice 437